Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Casey Lothamer
Area Counsel (Mid-Atlantic Area)
(Tax Exempt & Government Entities)

from: Matthew Giuliano
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(Employee Benefits, Exempt Organizations, and Employment Taxes)

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subject: Private Benefit, Indirect Self-Dealing, Correction, and Jeopardizing Investments

This Chief Counsel Advice responds to your request for assistance related to an examination of a tax-exempt private foundation (Foundation). Specifically, you asked whether the Foundation's unsecured loans to business entities founded, partially owned, and operated by a foundation manager cause the Foundation to be operated for private benefit, and whether the loans are indirect acts of self-dealing under section 4941(d)(1)(E) of the Internal Revenue Code.[1] In addition, you asked whether the Foundation's proposed transfer of promissory notes would constitute correction within the meaning of section 4941(e)(3) and whether the Foundation's modification of the promissory notes resulted in jeopardizing investments under section 4944.

As discussed below, we conclude that: (1) the loans cause the Foundation to be operated for the private benefit of the foundation manager and associated business entities; (2) the loans are indirect acts of self-dealing under section 4941(d)(1)(E); (3) the proposed transfer of the promissory notes would not constitute correction within the meaning of section 4941(e)(3); and (4) modification of the promissory notes resulted in jeopardizing investments under section 4944. This advice may not be used or cited as precedent.

[1] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended.

<u>LEGEND</u>

Foundation	=	
State 1	=	
Date 1	=	
Date 2	=	
Foundation Manager 1	=	
Foundation Manager 2	=	
A	=	
B	=	
Company 1	=	
Company 2	=	
State 2	=	
C	=	
D	=	
E	=	
F	=	
G	=	
H	=	
I	=	
J	=	
Date 3	=	
K	=	
Date 4	=	
L	=	
Year 1	=	
Year 2	=	
Year 3	=	
Year 4	=	
Year 5	=	
Year 6	=	
Year 7	=	
Year 8	=	
Year 9	=	
Year 10	=	
Year 11	=	
Year 12	=	
Year 13	=	
Year 14	=	
Year 15	=	
Year 16	=	

FACTS

The Foundation was incorporated under State 1 law on Date 1 and recognized by the IRS as a private nonoperating foundation described in sections 501(c)(3) and 509(a) on Date 2, retroactive to its date of formation. The Foundation was initially funded with stock by spouses, Foundation Manager 1 and Foundation Manager 2 (collectively, the Foundation Managers).

Since Year 1, Foundation Manager 1 and Foundation Manager 2 have served as the sole members of the Foundation's board and as its only officers and are therefore "foundation managers" within the meaning of section 4946(b)(1).[2] Although both Foundation Manager 1 and Foundation Manager 2 are board members and officers of the Foundation, it appears that during the years at issue, all investment decisions on behalf of the Foundation, including whether, to whom, and on what terms to issue loans, were made at the sole discretion of Foundation Manager 1.

Between Year 3 and Year 14, the Foundation issued at least A unsecured balloon loans totaling over $B in principal to two companies: Company 1 and Company 2. Company 1 was formed in Year 4 by Foundation Manager 1. Foundation Manager 1 served as Company 1's and and, in Year 7, Foundation Manager 1 owned more than 35 percent of Company 1's voting stock. After Year 7, Foundation Manager 1's interest in Company 1 decreased below 35 percent. In Year 15, Company 1 was acquired by an unrelated company. Company 2 was formed by Foundation Manager 1 as a State 2 limited liability company in Year 2. State 2 is a community property state. Prior to Year 13, Foundation Manager 1 owned C percent of the profits interest in Company 2[3] and served as a of the LLC. Foundation Manager 2 was also active in Company 2's operations and managed the company's day-to-day operations. In Year 13, Foundation Manager 1 and Foundation Manager 2 acquired 100 percent of Company 2 by buying out the D-percent interest held by Foundation Manager 1's . Foundation Manager 1 and Foundation Manager 2 reported Company 2's income in Year 13 and Year 14 on Form 1040 Schedule C and Company 2 did not file partnership returns for those tax years. It therefore appears that Foundation Manager 1 and Foundation Manager 2 elected to treat Company 2 as disregarded as an entity separate from its owners in Year 13 and that the Foundation Managers continued to treat Company 2 as a disregarded entity in Year 14.[4] Company 2 filed partnership

[2] Section 4946(b)(1) provides that the term "foundation manager" means, with respect to any private foundation, an officer, director, or trustee of a foundation (or an individual having similar powers or responsibilities).

[3] The remaining D-percent interest was owned by Foundation Manager 1's . Interests held by , including , are not aggregated with the interests of a disqualified person for purposes of determining whether a corporation or partnership is a disqualified person with respect to a private foundation because disqualified persons own more than a 35-percent interest in such corporation or partnership. *See* section 4946(d).

[4] Rev. Proc. 2002-69, 2002-2 C.B. 831, provides that if a husband and wife as community property owners treat a limited liability company as a disregarded entity (or, alternatively, as a partnership) for federal tax purposes, the IRS will accept that position for federal tax purposes. If the LLC is treated as a

returns for the Year 15 and Year 16 tax years; however, it does not appear that a Form 8832, *Entity Classification Election*, was filed to change Company 2's entity classification to that of a partnership.[5]

The loans to Company 1 and Company 2 generally provided for a -year repayment period with interest to be paid quarterly at the percent. Company 1 received E loans from the Foundation, with the largest loans occurring in Year 6 and Year 7, when Company 1 received $F and $G, respectively, from the Foundation. Company 1 paid interest quarterly and, in Year 15, had an outstanding principal balance of $H. Company 2 received at least I loans from the Foundation, with loans received each year between Year 3 and Year 12. Company 2 failed to make interest payments on these loans in Year 4, Year 5, Year 7, Year 12, and Year 13. As of year-end Year 12, Company 2 owed the Foundation $J in unpaid principal. At year-end Year 12, the face value of the Foundation's loans to Company 1 and Company 2 comprised over percent of its assets by fair market value as reported on its Form 990-PF, and the loans comprised almost percent of its assets by book value at the beginning of calendar-year Year 13. The Foundation did not keep board meeting minutes reflecting approval of the loans.

In Year 10, Year 12, and Year 14, extensions were granted on the Company 1 loans through letters signed by Foundation Manager 1 as Company 1's . Extensions were also granted on the Company 2 loans in Year 9 and Year 10. The extension letter in Year 10 was signed by Foundation Manager 1 as Company 2's .

In Year 13, Foundation Manager 1 approached the Foundation's tax return preparer and administrative services provider (Return Preparer), regarding his plan to purchase all of the remaining equity in Company 2. In emails to the Return Preparer, Foundation Manager 1 raised concerns that purchasing additional Company 2 shares might cause Company 2 to become a disqualified person with respect to the Foundation and might violate the prohibition on self-dealing due to the outstanding loans between the Foundation and Company 2. In order to remove the Company 2 loans from the Foundation's books, the Return Preparer proposed that the Foundation grant the Company 2 notes to public charities at a zero-dollar value.

In preparation for the planned transfers, the Foundation and Company 2 agreed to modify the terms of the notes. Under the terms of the modification agreement, the repayment period was extended by years to Date 3, and the interest rate was reduced to percent. Foundation Manager 1 signed the modification agreement on

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partnership, appropriate partnership returns must be filed. A change in reporting position will be treated for federal tax purposes as a conversion of the entity.

[5] Section 301.7701-3(c)(1)(i) allows an eligible entity to elect to change its classification by filing Form 8832, *Entity Classification Election*, with the service center designated on Form 8832. In certain cases, a request for relief under Treas. Reg. § 301.9100 can be made to retroactively change an organization's entity classification, if no such election was timely made pursuant to the rules set forth in Treas. Reg. § 301.7701-3(c)(1)(iii). However, to qualify for such relief a taxpayer must generally show that the taxpayer acted reasonably and in good faith, and that the grant of relief will not prejudice the interests of the government. *See* Rev. Proc. 2024-1, 2024-1 I.R.B. 1; Treas. Reg. § 301.9100-3(a).

behalf of both the Foundation and Company 2. In September Year 13, Foundation Manager 1 directed the Return Preparer to assign the Company 2 notes to K public charities and requested that the assignments be dated as of Date 4, a date approximately months prior.

Although the Return Preparer reported the transfers on the Foundation's Year 13 Form 990-PF as if they had occurred, the notes were never transferred. Consequently, the Foundation continued to hold the Company 2 notes after Foundation Manager 1 and Foundation Manager 2 acquired 100 percent of the interest in Company 2, and neither the Foundation nor the Foundation Managers discovered the failed transfers until the Service initiated its examination.

The Foundation concedes that an act of self-dealing under section 4941(d)(1)(B) occurred with respect to the Company 2 notes as of Year 13. The Foundation has proposed that this act of self-dealing can be corrected by having the Foundation transfer the Company 2 notes to public charities as initially planned.

ISSUE 1: PRIVATE BENEFIT

Did the making of A unsecured balloon loans (collectively constituting substantially all of the Foundation's assets) to business entities founded, partially owned, and operated by a foundation manager and the repeated extension of those loans cause the Foundation to be operated more than insubstantially in furtherance of a nonexempt purpose (serving the private interests of the foundation manager and the associated business entities)?

CONCLUSION

Yes, the Foundation's making of A unsecured balloon loans (collectively constituting substantially all of the Foundation's assets) to business entities founded, partially owned, and operated by a foundation manager and the repeated extension of those loans served the private interests of the foundation manager and the associated business entities, resulting in the Foundation operating more than insubstantially in furtherance of a nonexempt purpose.

LAW

Section 501(c)(3) provides exemption under section 501(a) for organizations organized and operated exclusively for one or more exempt purposes (e.g., religious, charitable, or educational).

Treas. Reg. § 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) provides that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. To satisfy this requirement, an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

Rev. Rul. 67-5, 1967-1 C.B. 123, ruled that a foundation controlled by the creator's family and operated to enable the creator and his family to engage in financial activities beneficial to them but detrimental to the foundation was operated for a substantial nonexempt purpose and served the private interests of the creator and his family. The foundation, therefore, was not entitled to exemption under section 501(c)(3).

Better Business Bureau of Washington, D.C., Inc. v. United States, 326 U.S. 279 (1945), held that the presence of a single nonexempt purpose, if substantial in nature, will preclude exemption regardless of the number or importance of truly exempt purposes.

Founding Church of Scientology v. United States, 412 F.2d 1197 (Ct. Cl. 1969), held that an organization was not entitled to exemption under section 501(c)(3), in part, because that organization issued loans to its founder and his family, resulting in the inurement of net earnings to private individuals. The Court of Claims noted in this case that "the very existence of a private source of loan credit from an organization's earnings may itself amount to inurement of benefit."

Western Catholic Church v. Commissioner, 73 T.C. 196 (1979), considered whether a church that invested in an office building to meet the needs of one of the church founder's businesses and that engaged in loan transactions with the founder and his businesses qualified for exemption under section 501(c)(3). The Tax Court concluded that when an organization's "investments are dictated in part by the needs of private interests, it cannot be said that [the organization] was operated exclusively for the public benefit." In addition, the Court found that the church was operated by the founder "as an 'incorporated pocketbook'" into which the founder could transfer excess personal funds and claim tax deductions while still retaining control of the funds and using them for nonexempt purposes. The Court therefore concluded that the church was not operated exclusively for exempt purposes and that the Service properly revoked the church's tax exemption.

<u>ANALYSIS</u>

Section 501(c)(3) exempts from federal income tax organizations organized and operated exclusively for one or more exempt purposes (e.g., religious, charitable, or educational). An organization will be regarded as operated exclusively for exempt purposes only if it engages primarily in activities that accomplish such exempt purposes.[6] An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose. In addition, an organization will not be regarded as organized and operated exclusively for exempt purposes unless it serves public rather than private interests.[7] Whether an organization is organized and operated exclusively for exempt purposes is determined based on the facts and circumstances of each case.[8] An organization claiming section 501(c)(3) status bears the burden to establish that it is not operated for the benefit of private interests.[9]

When an exempt organization serves as a private source of credit for its founder, that organization serves private rather than public interests.[10] In this case, the Foundation made A unsecured loans, totaling over $B in principal, to two companies founded, partially owned, and operated by a Foundation officer and board member—Foundation Manager 1. Through his control of the Foundation's investment decisions, Foundation Manager 1 was able to direct significant amounts of capital to his two businesses. Company 1 received significant loans from the Foundation during its early years of existence, at one point receiving $G from the Foundation in a single year. Company 2 also received regular cash infusions from the Foundation, receiving loans for almost every year of its existence (Years 3, 4, 5, 6, 7, 8, 9, 10, 11, and 12). At the beginning of calendar year Year 13, the Foundation's loans to Company 1 and Company 2 comprised substantially all of its assets: almost percent of its assets by book value as reported on its Year 13 Form 990-PF and over percent of its assets by fair market value as reported at year-end on its Year 12 Form 990-PF. It therefore appears that the Foundation was operated by Foundation Manager 1 as an "incorporated pocketbook" into which he could transfer assets while still retaining control over those assets and directing them toward his private business interests. Such an organization serves private interests and does not qualify for exemption under section 501(c)(3).[11]

The benefits to Company 1, Company 2, and Foundation Manager 1, however, go beyond the dollar amounts received from the Foundation. By obtaining loans from the Foundation rather than a commercial lender, Company 1 and Company 2 avoided the delays, inconveniences, and formalities of applying for commercial loans. In addition, due to Foundation Manager 1's position on both sides of the loan transactions, it was unlikely that the Foundation would take steps to enforce the loan terms if either Company 1 or Company 2 failed to honor the terms of the loan agreements. Indeed, the Foundation did not seek to enforce the terms of the loan agreements when Company 2

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[6] Treas. Reg. § 1.501(c)(3)-1(c)(1).

[7] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

[8] *See, e.g.*, *B.S.W. Group, Inc. v. Comm'r*, 70 T.C. 352, 358 (1978); *est of Hawaii v. Comm'r*, 71 T.C. 1067, 1079 (1979).

[9] Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii); *see also Easter House v. United States*, 12 Cl. Ct. 476, 487 (1987) ("[I]t is the responsibility of an organization to establish that it serves a public rather than private interest.").

[10] *See Founding Church of Scientology*, 412 F.2d at 1202 ("Indeed, the very existence of a private source of loan credit from an organization's earnings may itself amount to inurement of benefit."); *see also Easter House*, 12 Cl. Ct. at 488; *Unitary Mission Church of Long Island v. Comm'r*, 74 T.C. 507, 515 (1980).

[11] *See Western Catholic Church*, 73 T.C. at 214.

failed to make interest payments in Years 4, 5, 7, 12, and 13. Despite Company 2's failure to consistently pay interest on its existing loans, the Foundation continued to lend to Company 2, providing loans for almost every year of its existence. Under these circumstances, it is reasonable to conclude that the Foundation's decisions to make those loans to Company 2 were motivated more by Company 2's continued need for funds rather than for any return provided to the Foundation. When an organization's investments are dictated in part by the needs of private interests, that organization is not operated exclusively for the public benefit.[12]

When a foundation is used as a vehicle for activities advantageous to its creator and his family and as a source of funds to finance those activities, that foundation is operated for a substantial nonexempt purpose: serving the private financial interests of its creator.[13] In this case, the Foundation's two-person board was fully controlled by Foundation Manager 1 and Foundation Manager 2, and Foundation Manager 1 and Foundation Manager 2 used this control to direct Foundation assets toward business entities (Company 1 and Company 2) in which they and (with respect to Company 2) a held interests, serving the private interests of Foundation Manager 1, Foundation Manager 2, Company 1, and Company 2 more than insubstantially. Although Foundation Manager 1 has stated that the loans to Company 1 and Company 2 were reasonable investment decisions, Foundation Manager 1's significant involvement in Company 1 and Company 2 as a founder, officer, and partial owner calls into question whether the loans were reasonable investments. The lack of any contemporaneous records or board minutes reflecting review of the loans by disinterested Foundation directors or discussion of alternative investments further undercuts the assertion that the loans to Company 1 and Company 2, repeated extensions, and subsequent modifications of the Company 2 loans were made in the best interests of the Foundation or reflect reasonable, disinterested investment decisions. Taking the facts of this case as a whole, the Foundation's A unsecured loans to Company 1 and Company 2 served the private interests of the Foundation Managers by providing a private source of credit for their business interests. The Company 1 and Company 2 loans therefore caused the Foundation to be operated for a substantial nonexempt purpose and revocation of the Foundation's tax-exempt status is appropriate.

The Foundation has stated that revocation of its tax-exempt status would be inappropriate because it has carried out a charitable program commensurate in scope with its resources and has made over $L in grants to charitable organizations during its existence. However, to be described in section 501(c)(3), no more than an insubstantial part of an organization's activities may be in furtherance of a nonexempt purpose.[14] The presence of a single nonexempt purpose, if substantial in nature, will preclude exemption under section 501(c)(3) regardless of the number or importance of truly exempt activities.[15] As discussed above, making A unsecured loans, totaling over $B, to

[12] *Id.*
[13] Rev. Rul. 67-5.
[14] *See* Treas. Reg. § 1.501(c)(3)-1(c)(1).
[15] *See Better Business Bureau of Washington, D.C.*, 326 U.S. at 283.

business entities founded, operated, and partially-owned by a foundation manager served the private interests of the foundation manager and associated business entities, resulting in the Foundation's operation for a substantial nonexempt purpose. Revocation of the Foundation's tax-exempt status is therefore appropriate regardless of the Foundation's other activities.

ISSUE 2: INDIRECT SELF-DEALING UNDER SECTION 4941(D)(1)(E)

Did indirect acts of self-dealing occur under section 4941(d)(1)(E) when the Foundation loaned substantially all of its assets on an unsecured basis to two business entities that were founded, partially owned, and operated by a disqualified person, but in which the disqualified person owned less than a 35-percent interest?

CONCLUSION

Yes, indirect acts of self-dealing under section 4941(d)(1)(E) occurred when the Foundation loaned substantially all of its assets on an unsecured basis to two business entities that were founded, partially owned, and operated by a disqualified person, but in which the disqualified person owned less than a 35-percent interest. The loans in this case constituted the use of the Foundation's assets for the benefit of a disqualified person.

LAW

Section 4941(a)(1) imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation.

Section 4941(d)(1)(B) provides that the term "self-dealing" includes any direct or indirect lending of money or other extension of credit between a private foundation and a disqualified person.

Section 4941(d)(1)(E) provides that the term "self-dealing" includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

Section 4946 defines the term "disqualified person" for purposes of section 4941. Section 4946(a)(1) provides, in pertinent part, that the term "disqualified" person means, with respect to a private foundation, any person who is:

(A) a substantial contributor to the foundation;
(B) a foundation manager (within the meaning of subsection (b)(1));
(C) an owner of more than 20 percent of the total combined voting power of a corporation; the profits interest of a partnership; or the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation;
(D) a member of the family (as defined in subsection (d)) of any individual described in subparagraph (A), (B), or (C);

(E) a corporation of which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the total combined voting power;
(F) a partnership in which persons described in subparagraph (A), (B), (C), or (D) own more than 35 percent of the profits interest; or
(G) a trust or estate in which persons described in subparagraph (A), (B), (C), or (D) hold more than 35 percent of the beneficial interest.

Section 4946(a)(2) provides that the term “substantial contributor” means a person who is described in section 507(d)(2). Section 507(d)(2) defines a “substantial contributor” as any person who contributed or bequeathed an aggregate amount of more than $5,000 to the private foundation, if such amount is more than two percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from such person.

Section 4946(b)(1) provides that the term “foundation manager” means, with respect to any private foundation, an officer, director, or trustee of a foundation (or an individual having powers or responsibilities similar to those of officers, directors, or trustees of the foundation), and, with respect to any act (or failure to act), the employees of the foundation having authority or responsibility with respect to such act (or failure to act).

Treas. Reg. § 53.4941(d)-1(b)(4) provides that a transaction between a private foundation and an organization which is not controlled by the foundation (within the meaning of Treas. Reg. § 53.4941(d)-1(b)(5)), and which is not described in section 4946(a)(1)(E), (F), or (G) because persons described in section 4946(a)(1)(A), (B), (C), or (D) own no more than 35 percent of the total combined voting power or profits or beneficial interest of such organization, shall not be treated as an indirect act of self-dealing between the foundation and such disqualified persons solely because of the ownership interest of such persons in such organization.

Treas. Reg. § 53.4941(d)-2(f)(2) provides that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or assets will not, by itself, make such use an act of self-dealing.

Rev. Rul. 77-160, 1977-1 C.B. 351, provides that payment of a disqualified person’s church membership dues by a private foundation is not an incidental or tenuous benefit and is an act of self-dealing under section 4941(d)(1)(E).

Rollins v. Commissioner, T.C. Memo. 2004-260, held that a qualified employee plan trustee engaged in prohibited transactions under section 4975(c)(1)(D) when the trustee caused the plan to lend money to three entities in which the trustee owned minority (less than 35-percent) interests. The loan principal was repaid for each of the loans. Although the promissory notes claimed a security interest (generally machinery and equipment of the companies), no documentation was provided of any security interest under the U.C.C. that would have protected the plan against other creditors of the entities. The Tax Court concluded that the trustee failed to show that the loans were not a use of plan income or assets for the benefit of the trustee. Section 4975(c)(1)(D) is a provision that closely parallels section 4941(d)(1)(E) and treats as a prohibited transaction a direct or indirect "transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan."

ANALYSIS

Section 4941(a)(1) imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation. The term "disqualified person" is defined in section 4946 and includes, in pertinent part, substantial contributors to the foundation (section 4946(a)(1)(A)), foundation managers (section 4946(a)(1)(B)), and family members of a substantial contributor or foundation manager (section 4946(a)(1)(D)). Under section 4946(a)(1)(E) and (F), a corporation or a partnership will be treated as a disqualified person if a substantial contributor, foundation manager, or family member of a substantial contributor or foundation manager owns more than 35 percent of the total combined voting power (in the case of a corporation) or the profits interest (in the case of a partnership).

The Service, the Foundation, and Foundation Manager 1 agree that Foundation Manager 1 and Foundation Manager 2 are disqualified persons with respect to the Foundation under section 4946(a)(1)(A), (B), and (D). During the years under exam, Foundation Manager 1 owned less than 35 percent of Company 1's total combined voting power and Company 1 was not a disqualified person with respect to the Foundation. The Service also agrees that prior to Year 13,[16] Company 2 was not a disqualified person with respect to the Foundation because the Foundation Managers' C-percent profits interest in Company 2 was less than the greater-than-35-percent interest required for disqualified-person status under section 4946(a)(1)(F).

Section 4941(d)(1)(B) provides that the term "self-dealing" includes any direct or indirect lending of money or other extension of credit between a private foundation and a disqualified person. Company 1 and, prior to Year 13, Company 2 were not disqualified persons with respect to the Foundation, and therefore the A loans from the Foundation to Company 1 and Company 2 do not fall within the terms of section 4941(d)(1)(B). However, the fact that the loans are not described in section 4941(d)(1)(B) is not the end of the analysis. The loan transactions resulted in the transfer of over percent of the Foundation's assets by fair market value to entities founded, partially owned, and operated by Foundation Manager 1, who also controlled the Foundation's lending decisions. Therefore, the loans must also be assessed under section 4941(d)(1)(E) to determine whether the loans constitute the use of Foundation assets for the benefit of a disqualified person (Foundation Manager 1) and therefore as indirect acts of self-dealing.

[16] Following the Foundation Managers' acquisition of 100 percent of the interest in Company 2 in Year 13, it appears that the Foundation Managers elected to treat Company 2 as a disregarded entity. Company 2's activities, including any acts of self-dealing between Company 2 and the Foundation, would therefore be treated as activities of the Foundation Managers beginning in Year 13.

Section 4941(d)(1)(E) provides that the term “self-dealing” includes any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation. The Company 1 and Company 2 loans fall within the literal terms of section 4941(d)(1)(E). The loans constituted a use of the Foundation’s assets, and, for the reasons discussed in Issue 1 above, this use of Foundation assets benefited a disqualified person by enabling Foundation Manager 1 to obtain financing for his two businesses. Therefore, the Company 1 and Company 2 loans constituted acts of indirect self-dealing between the Foundation and Foundation Manager 1 under section 4941(d)(1)(E).

This conclusion is supported by the Tax Court’s decision in *Rollins v. Commissioner*.[17] In *Rollins*, the Tax Court concluded that loans made by the trustee of a qualified plan to business entities in which the trustee owned minority interests constituted the use of plan assets for the benefit of a disqualified person and therefore were prohibited transactions under section 4975(c)(1)(D).[18] Section 4975 imposes an excise tax on prohibited transactions between a disqualified person and a qualified plan similar to the section 4941 excise tax on acts of self-dealing between disqualified persons and private foundations.[19] Similar to section 4941(d)(1)(E), section 4975(c)(1)(D) provides that the term “prohibited transaction” includes any “transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a plan.”

In *Rollins*, each business entity that received loans was not a disqualified person with respect to the plan because the trustee’s interest in each entity was less than 35 percent. However, in analyzing whether the loans constituted prohibited transactions under section 4975(c)(1)(D), the Tax Court found it significant that the trustee, who was an officer of each of the obligor entities, sat on both sides of the loan transactions. The trustee made the decision to lend the plan’s funds, and the trustee also signed the promissory notes on behalf of the borrowers. The Court found that this activity “flies in the face of the general thrust of [section 4975].”[20] The Court also noted that it is unnecessary for plan assets to be transferred to disqualified persons for there to be a violation of section 4975(c)(1)(D). Thus, the fact that none of the business entities was a disqualified person with respect to the plan was irrelevant to whether there had been a use of plan assets for the benefit of the trustee. The Court ultimately concluded that the trustee failed to show that he did not benefit from the plan’s loans to the business entities and that the loans constituted prohibited transactions under section 4975(c)(1)(D).

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[17] *Rollins*, T.C. Memo. 2004-260.

[18] *Id.*

[19] Indeed, the Tax Court noted in *Rollins* that the close relationship between sections 4941 and 4975 is evident in “the general structures” of sections 4941 and 4975 and in “the identity of many elements of the definitions of ‘prohibited transaction’ . . . and ‘self-dealing.’” Legislative history for the Employee Retirement Income Security Act (ERISA) confirms that Congress intended section 4975 to parallel section 4941. *See* S. REP. NO. 93-383, at 97 (1973) (noting that the committee bill generally “defines as prohibited transactions the same type of transactions that constitute prohibited self-dealings with regard to private foundations, with modifications that are appropriate in the employee benefit trust area.”).

[20] *Rollins*, T.C. Memo. 2004-260.

The Tax Court's analysis in *Rollins* is equally applicable to the Company 1 and Company 2 loans and supports the conclusion that the loans are acts of self-dealing under section 4941(d)(1)(E). Similar to the trustee in *Rollins*, Foundation Manager 1 sat on both sides of the loan transactions. Foundation Manager 1 controlled the decision to loan Foundation funds to both Company 1 and Company 2 as a Foundation manager. At the same time, Foundation Manager 1 also served as Company 1's and Company 2's , owned interests in both, and agreed to extensions of the Foundation loans on behalf of both entities. Just as in *Rollins*, the fact that neither Company 1 nor Company 2 was a disqualified person with respect to the Foundation is irrelevant to the determination of whether the loans to those entities benefited Foundation Manager 1. As discussed in Issue 1, above, the benefit to Foundation Manager 1 from the loan transactions was substantial. Although, unlike in *Rollins*, Foundation Manager 1 did not hold the largest interest in Company 1 and Company 2, section 4941(d)(1)(E) does not require that a disqualified person hold the largest interest in an entity that benefits from the use of Foundation assets for an act of self-dealing to occur.[21] Foundation Manager 1 founded both entities, served as an officer of one and a of the other, and owned significant interests in both. Under these circumstances the $B in loans from the Foundation to Company 1 and Company 2 constituted a use of Foundation assets for the benefit of a disqualified person and therefore constituted indirect acts of self-dealing under section 4941(d)(1)(E).

Treas. Reg. § 53.4941(d)-1(b)(4) provides that a transaction between a private foundation and an organization which is not a disqualified person because persons described in section 4946(a)(1)(A), (B), (C), or (D) own no more than 35 percent of the total voting power, profits interest, or beneficial interest shall not be treated as an indirect act of self-dealing between the foundation and such disqualified persons "*solely because of the ownership interest* of such persons in such organization" (emphasis added). By implication, a transaction between a private foundation and an organization in which a disqualified person owns less than a 35-percent interest can result in an indirect act of self-dealing if there are facts and circumstances, in addition to the disqualified person's ownership interest, to suggest that self-dealing has occurred. Here, in addition to owning interests in Company 1 and Company 2, Foundation Manager 1 controlled the Foundation's investment decisions and used that control to lend $B from the Foundation to business entities he founded, partially owned, and operated. The Foundation did not maintain board meeting minutes with respect to the loan transactions nor has it presented records to show whether the board considered the conflict of interest presented by the loans or whether alternative investments were considered. Under these facts and circumstances, and consistent with the Tax Court's decision in *Rollins*, the loan transactions between the Foundation and Company 1 and Company 2 constituted indirect acts of self-dealing under section 4941(d)(1)(E).

Treas. Reg. § 53.4941(d)-2(f)(2) provides that the fact that a disqualified person receives an incidental or tenuous benefit from the use by a foundation of its income or

[21] Moreover, the Company 1 and Company 2 loans were unsecured, providing a further benefit to Foundation Manager 1 and his business interests.

assets will not, by itself, result in an act of self-dealing. Thus, the public recognition received by a disqualified person from a foundation's charitable activities does not result in an act of self-dealing because the benefit is incidental and tenuous.[22] In contrast, when a disqualified person receives an economic benefit from a private foundation, such as through the payment of membership dues by the foundation, the benefit is not incidental or tenuous.[23] In this case, Foundation Manager 1 was able to obtain $B in financing for his business entities through the Foundation's loans. The loans collectively constituted over percent of the Foundation's assets by fair market value and were made on terms unduly favorable to the business entities (unsecured, with loan extensions liberally granted). The benefit from the loans was economic in character and substantial by any measure. Accordingly, the benefit to Foundation Manager 1 from the Company 1 and Company 2 loans cannot be considered incidental or tenuous.

ISSUE 3: CORRECTION OF THE COMPANY 2 LOAN TRANSACTIONS

Would the Foundation's proposed assignment and distribution to public charities of the Company 2 promissory notes, the obligor of which is a disqualified person, constitute correction of a self-dealing transaction?

CONCLUSION

No, the proposed assignment and distribution of promissory notes to public charities would not constitute correction.

LAW

Section 4941(e)(3) provides that the term "correction" means, with respect to any act of self-dealing, undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards.

Treas. Reg. § 53.4941(e)-1(c)(4)(i) provides that in the case of the use by a disqualified person of property owned by a private foundation, undoing the transaction includes, but is not limited to, terminating the use of such property. In addition, the disqualified person must make certain payments to the private foundation.

Treas. Reg. § 53.4941(e)-1(c)(4)(ii), Examples 1, 2, and 3, illustrate acts of self-dealing in which disqualified persons rented office space from private foundations. Each example provides that in order to correct the act of self-dealing, the disqualified person must terminate his use of the property.

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[22] *See* Treas. Reg. § 53.4941(d)-2(f)(2); *see also* Rev. Rul. 73-407, 1973-2 C.B. 383 (contribution by a private foundation to a public charity on condition that the charity change its name to that of a substantial contributor to the foundation does not constitute an act of self-dealing under section 4941(d)(1)(E)).

[23] *See* Rev. Rul. 77-160.

ANALYSIS

In Year 13, the Foundation Managers acquired 100 percent of the interest in Company 2. The Foundation has conceded that Company 2 became a disqualified person with respect to the Foundation under section 4946(a)(1)(F) (i.e., as a partnership) due to this change in ownership. The Foundation has also conceded that, due to the outstanding loans between the Foundation and Company 2, self-dealing under section 4941(d)(1)(B) occurred in Year 13. The Foundation has proposed to correct this self-dealing transaction by assigning and distributing the Company 2 notes (as modified in Year 13) to public charities. However, in subsequent correspondence, Company 2 took the position that, based on Rev. Proc. 2002-69, it was a disregarded entity in Years 13 and 14 but became a partnership in Year 15 when it began to file partnership returns.

In order to address the Foundation's correction proposal, Company 2's status as a disqualified person under section 4946 must first be established. Section 4946 does not directly address limited liability companies. Company 2's classification as a disqualified person under section 4946 therefore depends on its entity classification as a disregarded entity, partnership, or corporation. Rev. Proc. 2002-69 provides that when a limited liability company (or other qualified entity) is solely owned by a husband and wife as community property under state law, the Service will respect the treatment of that entity as either a disregarded entity or as a partnership. A change in reporting position will be treated for federal tax purposes as a conversion of the entity. In Year 13, the Foundation Managers, who are spouses, became the sole owners of Company 2. State 2 is a community property state. Therefore, the Foundation Managers were permitted under Rev. Proc. 2002-69 to treat Company 2 as a disregarded entity, and it appears that they did so beginning in Year 13.

Although Company 2 filed partnership returns in Years 15 and 16, no Form 8832, *Entity Classification Election*, was timely filed to change Company 2's entity classification to a partnership. Rev. Proc. 2002-69 does not permit spouses to make subsequent changes to the entity classification of a wholly owned LLC merely by changing filing positions, nor does the revenue procedure modify the requirement in Treas. Reg. § 301.7701-3(c)(1)(i) that an eligible entity must file Form 8832 to change its entity classification. Consequently, Company 2 remained a disregarded entity for federal tax purposes in Years 15 and 16. The activities of a disregarded entity, including any self-dealing, would be attributed to its owners, the Foundation Managers, who are disqualified persons with respect to the Foundation under sections 4946(a)(1)(A), (B), and (D).

This Office therefore agrees that self-dealing under section 4941(d)(1)(B) occurred in Year 13 but disagrees that Company 2 was a partnership described in section 4946(a)(1)(F) at any time between Years 13 and 16. As discussed above, Company 2 is properly treated as a disregarded entity beginning in Year 13, and its activities, including any self-dealing, would be attributed to its owners. In addition, as discussed in Issue 2, above, this Office also believes that the Company 2 loans constituted indirect self-dealing between the Foundation and Foundation Manager 1 under section

4941(d)(1)(E) prior to Year 13.[24] However, regardless of whether the act of self-dealing was between the Foundation and Company 2 or the Foundation and Foundation Manager 1, this Office concludes that the Foundation's proposed transfer of the Company 2 notes to public charities would not constitute correction as defined in section 4941(e)(3).

Section 4941(e)(3) defines correction of an act of self-dealing as "undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards." When an act of self-dealing involves the use of foundation property by a disqualified person, correction requires termination of the use of such property and the making of certain payments to the foundation by the disqualified person.[25] This correction standard is illustrated by three examples in Treas. Reg. § 53.4941(e)-1(c)(4)(ii). In each example, correction includes termination of the use of foundation property by the disqualified person.

The Foundation has proposed to correct the act of self-dealing with respect to Company 2 by assigning and distributing the Company 2 promissory notes to public charities. The effect of this distribution would be that the promissory notes would no longer be held by the Foundation and the Foundation would no longer be engaged in the extension of credit to a disqualified person. In other words, the Foundation has proposed to terminate its ownership interest in the notes so that the property used by Company 2 would no longer be "foundation property."

The proposed transfer of the Company 2 notes would not constitute correction as defined in Treas. Reg. § 53.4941(e)-1(c)(4) because it would not result in the termination of the use of property by the disqualified person. Assignment and transfer of the Company 2 promissory notes would transfer the Foundation's right to future interest and principal payments to the public charities, but the loans would still remain outstanding. Far from terminating the use of assets loaned by the Foundation to Company 2, the proposed transfer would permit Company 2 to continue to use the loaned funds until Date 3.

Section 4941(e)(3) requires undoing the act of self-dealing to the extent possible and placing the private foundation in a financial position not worse than that in which it would be if the disqualified person were dealing under the highest fiduciary standards. Transferring the Company 2 notes to public charities would not undo the loan transactions nor would it make the Foundation whole. Instead, the proposed correction

[24] This case presents a situation in which loan transactions that constituted indirect acts of self-dealing between the Foundation and Foundation Manager 1 under section 4941(d)(1)(E) also gave rise to direct acts of self-dealing under section 4941(d)(1)(B) due to the Foundation Managers' acquisition of the outstanding Company 2 interest and Company 2's treatment as a disregarded entity. As applied to the specific facts of this case, we believe that where two different theories support imposition of the section 4941(a)(1) tax on the same loan transactions, the excise tax should be imposed only once with respect to the loan transactions rather than imposed twice (i.e., once with respect to section 4941(d)(1)(E) and again with respect to section 4941(d)(1)(B)).

[25] *See* Treas. Reg. § 53.4941(e)-1(c)(4).

appears intended to allow Company 2 to continue its use of the loans, and on a long-term basis. Consequently, this Office concludes that the Foundation's proposed transfer of the Company 2 notes would not constitute correction under section 4941(e)(3). Correction of the Company 2 loan transactions should be accomplished consistently with the principles outlined in section 4941(e)(3) and Treas. Reg. § 53.4941(e)-1(c)(4). At a minimum, the Foundation's loans to Company 2 must be repaid.

ISSUE 4: APPLICATION OF SECTION 4944 TO THE COMPANY 2 NOTE MODIFICATIONS

Did the Year 13 modification of the Company 2 promissory notes to extend the loan term and to reduce the interest rate constitute a change in the form or terms of an investment under Treas. Reg. § 53.4944-1(a)(2)(iii), such that the Foundation will be considered to have entered into a new investment on the date of such change? If so, was this new investment a jeopardizing investment under section 4944?

CONCLUSION

The Year 13 modification of the Company 2 promissory notes constituted a change in the form or terms of an investment such that the Foundation will be considered to have entered into a new investment on the date of the modification. This new investment was a jeopardizing investment under section 4944.

LAW

Section 4944(a)(1) imposes an excise tax on any amount invested by a private foundation in a manner that jeopardizes the carrying out of any of the foundation's exempt purposes.

Treas. Reg. § 53.4944-1(a)(2)(i) provides, generally, that an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence, the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation is to be made on an investment-by-investment basis, in each case taking into account the foundation's portfolio as a whole. The determination of whether the investment of any amount jeopardizes the carrying out of a foundation's exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight.

Treas. Reg. § 53.4944-1(a)(2)(iii) provides that for purposes of section 4944, a private foundation which, after December 31, 1969, changes the form or terms of an investment will be considered to have entered into a new investment on the date of such change (unless the investment is acquired solely as a result of a corporate reorganization within the meaning of section 368(a)). The determination of whether such change jeopardizes the carrying out of the foundation's exempt purposes shall be made at the time of the change.

ANALYSIS

Section 4944(a)(1) imposes an excise tax on the making of any investment that jeopardizes the carrying out of a private foundation's exempt purposes. An investment is considered to jeopardize the carrying out of a foundation's exempt purposes if it is determined that the foundation managers, in making the investment, "have failed to exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes."[26] In exercising the requisite standard of care and prudence, foundation managers may take into account the expected return, the risks of rising and falling price levels, and the need for diversification within the investment portfolio. Once an investment has been determined not to jeopardize the carrying out of a foundation's exempt purposes, the investment shall never be considered to be a jeopardizing investment, even if the foundation subsequently realizes a loss.[27]

In general, the determination of whether an investment jeopardizes the carrying out of a foundation's exempt purposes is made as of the time that the foundation makes the investment.[28] However, Treas. Reg. § 53.4944-1(a)(2)(iii) provides that a private foundation that changes the form or terms of an investment will be considered to have entered into a new investment on the date of such change, unless subject to an exception not applicable here. A determination of whether such change in the investment jeopardizes the carrying out of the foundation's exempt purposes shall be made as of the time of the change.[29]

The Company 2 notes were Foundation investments. In Year 13, the Foundation and Company 2 agreed to amend the terms of the notes to reduce the annual interest rate from the percent to percent and to extend the loan term by years to Date 3. The changes in the note terms were changes in the terms of a Foundation investment. Therefore, the Foundation will be considered to have entered into a new investment on the date of the Year 13 modifications and a determination of whether the notes as modified constitute jeopardizing investments must be made as of the date of the change.

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[26] Treas. Reg. § 53.4944-1(a)(2)(i).
[27] *Id.*
[28] *Id.*
[29] Treas. Reg. § 53.4944-1(a)(2)(iii).

An investment is a jeopardizing investment if the foundation managers, in making such investment, fail to exercise ordinary business care and prudence, under the facts and circumstances, in providing for the financial needs of the foundation.[30] The Senate Committee on Finance report on the Tax Reform Act of 1969, which enacted section 4944, explains that the determination of whether an investment is jeopardizing is to be made "in accordance with a 'prudent trustee' approach."[31] The prudent trustee standard, also called the prudent investor standard, is a concept from trust law that requires the trustee to invest and manage the funds of the trust as a prudent investor would in light of the purposes, terms, distribution requirements, and other circumstances of the trust, and by exercising reasonable care, skill, and caution.[32] In assessing whether the prudent investor standard is satisfied, one factor to be considered is whether the trustee acted in the best interest of the trust beneficiary.[33] Thus, the presence of a conflict of interest between a foundation manager and a private foundation is a factor in assessing whether an investment is a jeopardizing investment for purposes of section 4944.

In this case, Foundation Manager 1 did not act prudently in agreeing to the Company 2 loan modifications. First, we note that Foundation Manager 1 had a major conflict of interest in making the loan modifications. At the time of the modifications, Foundation Manager 1 was in the process of acquiring, or had already acquired, 100 percent of the interest in Company 2. Foundation Manager 1 represented both Company 2 and the Foundation in their loan dealings, and there is no evidence of any kind of bargaining for the loan modifications. Moreover, the modifications were made in conjunction with the Foundation's plan to grant the notes to public charities to facilitate Foundation Manager 1's acquisition of Company 2. Modification of the loan terms was not necessary for the Foundation to distribute the notes to public charities. Modification would, however, have been advantageous for Company 2, which would benefit from a reduction in interest rate and -year extension of the loan term before the notes were transferred to third parties who would presumably seek to enforce the terms of the notes. At the very least, Foundation Manager 1 was not disinterested with respect to the modifications. Moreover, because the Foundation Managers were the Foundation's sole managers and board members, and both were involved in Company 2's activities, there were no independent board members who could review and approve the proposed modifications to ensure that they represented prudent, non-jeopardizing investments.[34] Given the

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[30] Treas. Reg. § 53.4944-1(a)(2)(i).
[31] S. REP. NO. 91-552, at 46 (1969).
[32] *See* RESTATEMENT (THIRD) OF TRUSTS § 90; UNIFORM PRUDENT INVESTOR ACT § 2.
[33] *See* RESTATEMENT (THIRD) OF TRUSTS § 90 cmt. c ("Under the prudent investor rule, the trustee must act with undivided loyalty and solely in the interests of the beneficiaries."); UNIFORM PRUDENT INVESTOR ACT § 5 cmt. ("A fiduciary cannot be prudent in the conduct of investment functions if the fiduciary is sacrificing the interests of the beneficiaries.").
[34] Although section 4944 does not require a foundation to follow any specific procedure when making an investment decision, the law of charitable organizations has recognized procedures that can be followed when a charity engages in a transaction with a related party. For example, comment d of section 2.02 of the Restatement of Charitable Nonprofit Organizations provides that "[a] typical procedure for disclosing and authorizing a transaction involving proposed self-dealing requires that (1) the fiduciary with the conflict disclose the conflict and all material facts and circumstances to all members of the board; (2) the fiduciary delegates the ultimate decision of whether to approve the

conflict of interest between Foundation Manager 1 and the Foundation, that the Company 2 loans represented a significant percentage of the Foundation's assets, and that the loan modifications were made in exchange for no consideration from Company 2, Foundation Manager 1 did not exercise ordinary business care and prudence when he agreed to the Company 2 note modifications.

Consideration of three additional facts leads to the conclusion that the Year 13 modifications were jeopardizing investments. First, the modifications extended the loan term by years, turning what had been short-term notes into long-term investments. Company 2 had already proven to be inconsistent in its payment of interest and principal on the notes, and a -year extension would have increased the Foundation's risk of loss. Second, the Foundation could have mitigated potential risks posed by the extension of the Company 2 notes by seeking to secure the loans. The Foundation did not do so, notwithstanding the fact that it had invested a significant part of its assets in Company 2 and Company 2 had previously shown itself to be inconsistent in honoring the terms of the notes. The Foundation also did not receive any other concession from Company 2, such as a payment of principal or interest, in exchange for its loan modifications in Company 2's favor. Third, the modifications resulted in a significant reduction in the interest rate from the percent to percent annual interest. The Foundation has not presented any contemporaneous records indicating the basis for the interest rate reduction or whether alternative options were considered. These loan modifications, taken together, were a significant benefit to Company 2 at the Foundation's expense. When these facts are considered together with Foundation Manager 1's presence on both sides of the transaction, it is apparent that the Year 13 loan modifications fell well short of the prudent investor standard and therefore constituted jeopardizing investments.

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Please call Christopher Hyde or Ward Thomas at 202-317-5800 if you have any further questions.

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conflicted transaction to all nonconflicted board members; and (3) the nonconflicted board members determine that the transaction is fair to the charity."